Chief Financial Officer's review

"We have delivered a solid performance with profits in line with expectations, supported by the growing strength of the Joint Venture vet business where our income grew 24.6%◊."

Financial highlights

The FY17 audited period represents the 52 weeks to 30 March 2017. The audited comparative period represents 53 weeks to 31 March 2016, but to provide a meaningful comparison, the more appropriate prior year period is the 52 weeks to 24 March 2016. All commentary in this statement in respect of the comparative period is based on the proforma 52-week period to 24 March 2016 unless otherwise stated.

		FY16 Audited 53 weeks to 31 March 2016	FY16 Proforma 52 weeks to 24 March 2016	FY17 Audited 52 weeks to 30 March 2017	Change On proforma 52 weeks to 24 March 2016
Revenue	**Revenue Split (£m)**				
	Food	390.0	382.5	395.1	3.3%
	Accessories	320.2	314.0	321.6	2.4%
	Total Merchandise	710.2	696.5	716.7	2.9%
	Services & other[1]	82.9	81.3	117.5	44.5%
	Total Group	793.1	777.8	834.2	7.2%
	Like-For-Like growth†	2.1%	2.2%	1.5%	
	Merchandise LFL†	1.4%	1.5%	0.8%	
	Services & other LFL†	10.0%	10.4%	7.9%	
	Revenue mix (% of total)				
	Merchandise	89.5%	89.5%	85.9%	(363) bps
	Services & Other	10.5%	10.5%	14.1%	363 bps
Gross margin	Merchandise Gross Margin	57.0%	57.0%	57.6%	56 bps
	Services & Other Gross Margin	32.9%	33.0%	33.3%	34 bps
	Total Gross Margin	54.5%	54.5%	54.2%	(35) bps
EBITDA	Pre-exceptional EBITDA[2]† (£m)	127.4	124.7	130.5	4.7%
	Pre-exceptional EBITDA margin[2]†	16.1%	16.0%	15.6%	(38) bps
Other income statement	Pre-exceptional PBT[2,3]† (£m)	97.3	95.3	96.4	1.1%
	Statutory PBT (£m)	92.1	90.2	95.4	5.8%
	Pre-exceptional basic EPS[2,3]† (p)	15.4	15.1	15.3	1.0%
	Statutory basic EPS	14.6	–	15.1	3.4%
	Dividend (p)	7.5	–	7.5	0%
Cash flow and leverage	Free cash flow† (£m)	71.6	77.8	64.6	(17.0)%
	CROIC†	22.1%	-	20.6%	(150)bps
	Leverage (ND/pre-exceptional EBITDA)†	1.3x	1.2x	1.2x	

1 Includes veterinary Joint Venture fees & other veterinary income, specialist referrals revenue, grooming salon revenue, revenue from live pet sales & insurance.
2 FY17 excludes £1.0m of costs related to the disposal of Farm Away Limited. FY16 52 & 53 weeks excludes £0.8m of acquisition related expenses.
3 FY16 52 & 53 weeks excludes an exceptional finance expense of £4.3m associated with the amortisation of capitalised fees from the previous finance facility.

◊ FY16 comparative information presented on a 52 week basis. For reconciliation to a 53 week statutory basis see page 179.
† Alternative Performance Measures (APMs) are defined and reconciled to IFRS information, where possible, on page 179.

Sales and revenue

Group revenue grew by 7.2%◊ to £834.2m (FY16: £777.8m◊), with good performance in Advanced Nutrition and pet services. Like-for-like sales (LFL) grew 1.5%◊†, driven by veterinary and grooming services, omnichannel, and Advanced Nutrition.

Merchandise revenue, which includes Food and Accessories, grew by 2.9%◊ to £716.7m (FY16: £696.5m◊), with LFL sales of 0.8%◊†. Whilst this reflects an overall slower performance in the business, we have also reduced Merchandise LFL space by around 0.5% during the year through the retrofit of services into existing stores.

Food revenue grew by 3.3%◊ to £395.1m (FY16: £382.5m◊), with strong performance in dog Advanced Nutrition and natural based treats, reflecting the ongoing trend for dog owners to feed a higher quality diet. Advanced Nutrition revenue grew by 4.1%◊ to £179.1m (FY16: £172.0m◊). Grocery food performance was soft, reflective of the overall market growth in this declining and highly competitive product area, alongside weak performance in wild bird food, which was tightly correlated with the warmer temperatures in the autumn.

Accessories revenue grew by 2.4%◊ to £321.6m (FY16: £314.0m◊). We saw excellent growth across dog accessories and an improved performance in Health & Hygiene. This was somewhat offset by weakness in aquatics accessories, an area in the store where space is typically reduced following vet practice and grooming salon retrofits.

Services revenue grew by 44.5%◊ to £117.5m (FY16: £81.3m◊), with LFL sales of 7.9%◊†. This reflects the acquisition of referral centres and another year of excellent growth in our vet practices and grooming salons. Growth in our Joint Venture (JV) veterinary practices was strong, generating total income of £47.1m (FY16: £37.8m◊), up 24.6%◊ compared with the prior year.

Gross margin

Group gross margin declined by 35bps◊ to 54.2% (FY16: 54.5%◊), driven primarily by the increasing mix of Services with the business.

Gross margin within Merchandise was 57.6%, an expansion of 56 bps◊ on the prior year (FY16: 57.0%◊), where we absorbed a negative foreign currency impact of £2.2m.

Gross margin within Services grew by 34 bps◊ to 33.3% (FY16: 33.0%◊), a very good outcome considering the dilutive mix impact from the acquisition of referral centres and was driven by strong gross margin accretion in our core first opinion vet business and a decline in low margin pet sales.

EBITDA and operating costs

Pre-exceptional EBITDA† of £130.5m represented a 4.7%◊ increase on the previous year (FY16: £124.7m◊), with a margin of 15.6% (FY16: 16.0%).

Selling and distribution expenses of £296.0m increased slightly as a percentage of Group revenue, to 35.5% (FY16: 35.3%◊). Within this, occupation costs (rent, service charges and other costs) again declined as a percentage of sales as we benefit from the rent and rates paid by vet practices within our stores, which contributed £10.7m (FY16: £9.1m◊). Colleague costs of £181.5m (FY16: £156.2m◊), increased as a percentage of sales, primarily due to the introduction of the National Living Wage at the start of the period, which led to additional wage costs of £1.6m.

Pre-exceptional administration expenses of £54.9m were 6.6% of revenue (FY16: 6.4%◊), where we are seeing growth in vet group and referral centre operating costs, alongside our investment in business systems. Exceptional administration costs of £1.0m are recognised in relation to the sale of the Group's equestrian retailing business, Farm Away Limited (see paragraph below).

Depreciation and amortisation, which is contained within our total operating costs, increased to £29.6m (FY16 £24.5m◊) as a result of the overall increase in, and type of, capital investments we make. Our increased investment in business systems to build our on-line capability results in assets that have a shorter depreciable life.

Finance expense

Pre-exceptional net finance expense† for the year was £4.5m, a reduction from the prior year (FY16: £4.8m◊) as a result of declining leverage.

Taxation, trading profit & EPS

Pre-exceptional pre tax profit† was £96.4m and grew by 1.1%◊ compared with the prior year (FY16: £95.3m◊). Statutory pre tax profit was £95.4m and grew by 5.8%◊ compared with the prior year (FY16: £90.2m◊).

Underlying total tax expense† for the period was £20.1m, a rate of 21% on pre-exceptional pre tax profit, and in line with our expected tax rate for the full financial year.

Pre-exceptional profit for the period†, after tax, was £76.3m (FY16: £75.5m◊) and pre-exceptional basic earnings per share† were 15.3 pence, growth of 1.0%◊ compared with the prior year (FY16: 15.1 pence◊).

Working capital

The underlying cash movement in trading working capital† was an inflow of £8.2m, with an increase in inventory of £5.0m and an decrease in trade receivables of £1.7m, offset by an increase of £11.5m in payables which reflects our efforts to drive a wide range of efficiencies.

We have also supported our younger first opinion veterinary practices with short term funding to underpin their growth. Such operating loans to Joint Venture practices support their day to day working capital management, but also enables them to support extended hours, additional services or capacity extensions. This increased the total reported trade receivables movement to £8.9m. We expect to continue this support to vet practices in the coming year to underpin the growth of the business.

Cashflow and capital structure

Cash flow generation remains good. Free cashflow† after interest, tax and before acquisitions was £64.6m (FY16: £77.8m◊), with a decline in the cash conversion rate to 49% (FY16: 62%◊) as a result of increased capital expenditure and cash working capital requirements compared with the prior year.

We acquired two veterinary specialist referral centres during the period, with cash outflows related to acquisitions of £14.8m. Dick White Referrals (DWR), based in Cambridgeshire, is one of the UK's largest small animal specialist referral centres. We acquired a 76% ownership stake in DWR for a cash consideration of £13.8m and will operate the practice as a shared venture model through which the founder, Professor Dick White, and the key clinicians, will retain 24% equity ownership.

Eye-Vet Referrals (EVR), based in Cheshire, is a dedicated ophthalmology centre with six veterinary clinicians. EVR already provides services to one of our referral centres, NorthWest Veterinary Specialists, as well as to other primary opinion veterinary practices. EVR will also operate as a shared venture, with the founders retaining 10% equity ownership.

The Group's leverage ratio at year end was 1.2x net debt: pre-exceptional EBITDA†. This is a slight reduction from the FY16 position of 1.3x (FY16 audited 53 week period), reflecting the cashflow requirements of acquisitions in the veterinary referrals market and increased working capital requirements during the year.

Looking forward, our capital structure and allocation policy remains as previously stated. We remain a cash generative business and our priority is to invest in areas that will expand the Group and deliver appropriate returns – as evidenced by our acquisitions in the veterinary referrals market. We are comfortable with a leverage position of up to 1.5x net debt/ EBITDA[5] under normal circumstances, moving to a maximum of around 1.75x in the event suitable investment or acquisition opportunities arise. We believe this maintains appropriate flexibility for our business, operating in a resilient market with strong cash generation capabilities. And dependent upon our acquisition outlook and if we do not foresee investment uses, it is our intention to return surplus free cashflow to shareholders through a combination of ordinary and special dividends.

Free cashflow† (£m)	FY16◊	FY17
Cash EBITDA[4] †	127.7	133.0
Working capital	5.0	(2.3)
Tax	(14.8)	(19.3)
Interest cost	(5.3)	(4.2)
Capex	(34.8)	(42.6)
Reported free cashflow	**77.8**	**64.6**

4 Defined as pre-exceptional EBITDA plus IFRS 2 share based payment charges.

£m	FY16 Audited 53 weeks to 31 March 2016	FY17
Opening net debt	(192.0)	(162.0)
Free cashflow†	71.6	64.6
Ordinary dividends paid	(27.9)	(39.9)
Acquisitions	(8.1)	(14.8)
Other	(5.6)	(1.6)
Closing net debt	(162.0)	(153.7)
Leverage (ND/pre-exceptional EBITDA†)	1.3x	1.2x

5 On an annualised basis.

◊ FY16 comparative information presented on a 52 week basis. For reconciliation to a 53 week statutory basis see page 179.

† Alternative Performance Measures (APMs) are defined and reconciled to IFRS information, where possible, on page 179.

Disposal of Ride-away

On 4 October 2016 the Group disposed of its equestrian retailing business, Farm Away Limited, which operated under the Ride-away brand. Sale proceeds were £0.7m, resulting in a loss on disposal of £0.7m. Costs of disposal of £0.3m are also recognised as an exceptional expense within the income statement.

Capital investment

Capital investment was £44.5m (FY16 53 week period: £41.5m), in line with our expectations, of which £5.8m is part of an energy savings programme to fit LED lighting and smart energy management systems in our store estate. This investment is part of a one-off £8m project, of which the remaining £3m will be invested in FY18, in line with our previous guidance.

Within the underlying capital investment, £11.1m is represented by the retrofit of services into our existing store estate, (FY16 53 week period £8.0m), where we increased both the number of retrofits, with more built on mezzanine floors. New store capital investment declined to £6.4m (FY16 53 week period: £11.5m) in line with our reduced rollout during the year, and investment in business systems also declined to £7.2m (FY16 53 week period: £10.0m) as we move out of the investment phase, and into the refreshment phase of our omnichannel developments.

Cash capital expenditure was £40.9m (FY16 53 week period: £36.8m).

Dividend

The Board has recommended a final dividend of 5.0 pence per share, giving a total dividend of 7.5 pence per share in respect of the 2017 financial year, equal with the prior year. Looking forward to the financial year 2018, the Board has committed to maintaining the ordinary dividend at the same level as the prior year.

The final dividend will be proposed by the Directors at the 2017 AGM and is in addition to the interim dividend of 2.5 pence per share, paid to shareholders on the 6 January 2017. The ex-dividend date will be 15 June 2017 and, if approved at the Company's forthcoming AGM, will be paid to shareholders on 14 July 2017 to those shareholders on the register at the close of business on 16 June 2017.

Foreign exchange outlook

The Group purchases products from Asia to a value of around US$55 million each year and our policy is to hedge up to 95% of forecast foreign exchange transactions on a rolling 12 month basis. The movement in hedged contract rates for FY17, which were at an average rate of 1.47 USD:GBP, created a £2.2m adverse cost to the Group. Our hedging requirements for FY18 are in place, at an average rate of 1.30 USD:GBP, which will have a negative impact of around £5m.

Accounting treatment of veterinary specialist referral centre

Three of our four veterinary specialist referral centres are structured as a shared venture ownership model, where Pets at Home maintains a minimum 75% controlling share, with the remaining shares owned by multiple clinician Shared Venture Partners (SVPs). This structure maintains strong commercial incentives for the existing SVPs to grow the businesses.

Under this ownership structure, Pets at Home has an option to buy the SVPs shares in the future, typically from three years and onwards post the point of acquisition. The potential value uplift in these shares is related to stretching profit performance targets of the referral centre and the accounting treatment of such an option is therefore structured as a forward contract.

The required accounting treatment of the referral centres is full consolidation of the income statement, balance sheet and cashflow. Within the income statement, the discounted future value of the SVPs shares is recognised as an expense over the period to which the option can be exercised, on our best estimate of the future value. In the event that the referral centres' long term stretching targets are achievable, a non cash charge will be recognised as a non-underlying expense within operating costs, which could be up to £2m in FY18.

Mike Iddon
Group Chief Financial Officer
25 May 2017